EXCEPTION

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BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission
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JIM IRVIN
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COMMISSIONER

IN THE MATTER OF THE COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA.

DOCKET NO. RE-00000C-94-165

STAFF'S EXCEPTIONS TO THE HEARING OFFICER'S PROPOSED ORDER

The Hearing Officer's recommendation in the above referenced matter was issued on May 6, 1998. Staff hereby submits these Exceptions, describing the appropriate resolution of Stranded Cost issues. Attached to these Exceptions, Staff has prepared a proposed Amendment, which, if adopted, will result in the Commission's adoption of the Staff position.

I. INTRODUCTION.

Numerous issues remain to be resolved as the Commission moves forward in our effort to restructure the electric generation industry. As correctly noted by the Hearing Officer, the resolution of so-called stranded cost issues is among the more complex and pressing of those matters. For this reason, again, as noted by the Hearing Officer, the stranded cost issues were segregated from the myriad of other issues and accorded an evidentiary hearing and briefing. The recommended Opinion and Order issued on May 6, 1998 reflects the Hearing Officer's efforts to resolve the stranded cost issues.

Consistent with the Hearing Officer's direction, Staff has continued to discuss stranded cost issues with the stakeholder groups and has continued attempts to refine, narrow and resolve issues in hopes of reaching a resolution of stranded cost concerns that is in the public interest. As a result of Staff's continued efforts, progress has been made. Accordingly, Staff's position with respect to an appropriate Order to be issued from this proceeding has been refined somewhat from that presented in our briefing of issues. These Exceptions represent the fruit of Staff's progress.

In Staff's judgment, all of the proposals reflected herein share several common traits. First, they reflect agreement of more parties on more issues than previous attempts at resolving stranded cost issues. Secondly, these proposals provide a means of resolving stranded cost issues that is in the public interest. Finally, and importantly, Staff believes that the record in this proceeding supports the adoption of these Exceptions. Staff urges the Commission to adopt these Exceptions and the accompanying Amendment to the Hearing Officer's recommendation to resolve stranded cost issues.

II. ADOPTION OF A POLICY FOR STRANDED COST RECOVERY.

At pages 11 through 13, the Hearing Officer proposes three options under which stranded cost recovery would be permitted and appears to permit each Affected Utility to choose among the three at it's option. Staff suggests that, instead, the Commission should adopt a policy indicating our preference for auction and divestiture as the preferred method for calculation of stranded costs. The record in this proceeding supports the notion that a divestiture approach provides the surest method of valuation of the generation assets. Indeed, divestiture is among the Hearing Officer's three alternative plans. Staff merely submits that it should be the policy preference and first choice of the Commission among the alternative permissible means of calculation.

In order to provide appropriate incentives for the Affected Utilities to select divestiture, Staff proposes that utilities voluntarily divesting of all generation assets, power purchase contracts and fuel contracts should be allowed the opportunity to recover 100% of unmitigated stranded costs, on an equal basis over a ten year period. The stranded cost recovery should be permitted in such a manner as to avoid triggering write-offs. If the stranded cost amount is determined to be negative, ratepayers should be entitled to receive 100 percent through a refund, negative surcharge, or other mechanism approved by the Commission. All customers connected to the Affected Utilities' grid should be required to pay their appropriate share through a CTC charge or through standard offer rates.

Staff does not propose mandating divestiture. In addition, Staff proposes that, for a divesting Affected Utility, unmitigated stranded costs would include reasonable employee severance and retraining costs necessitated by electric competition, where not otherwise provided. Unmitigated stranded cost would likewise include reasonable costs associated with the sale of generation assets. Such costs could include premiums or penalties associated with lease terminations or debt redemptions which might be specifically assignable to specific assets. Similarly, costs associated with transfer of fuel and transportation contracts and interests in jointly-owned generating facilities, as well as the tax consequences of all such transactions would affect the calculation of unmitigated stranded cost.

Each Affected Utility seeking to recover stranded cost would be required to submit a stranded cost recovery proposal for Commission consideration and would recover stranded costs only as approved by the Commission. Stranded cost recovery mechanisms and recovery periods would be as determined by the Commission, competitively neutral and subject to the Affected Utility bearing the burden of supporting its estimates of unmitigated stranded cost. Stranded cost shall be allocated among customer classes in a manner consistent with the respective Affected Utility's current tariff treatment for those customer classes.

Under Staff's proposed divestiture plan, no Affected Utility or its affiliate would be allowed to purchase generation assets at any divestiture auction of any Affected Utility. This provision would be subject to waiver by the Commission for good cause shown. For example, if one participant in a joint use facility was deemed best able to efficiently operate the plant, thereby maximizing the value of the plant, a waiver of this provision may be considered, which would allow the Affected Utility to bid on the facility. Any such bid would be required to be performed through a non-utility affiliate, consistent with all current or subsequently enacted affiliated interest rules of the Commission.

Each Affected Utility choosing divestiture should be required to submit a divestiture plan no later than October 1, 1998. The sale of generating assets should be completed prior to January 1, 2001, unless otherwise approved by the Commission. The requirements of a true-up mechanism should be established at the time the Commission acts on an Affected Utility's stranded cost filing.

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III. AFFECTED UTILITIES CHOOSING NOT TO DIVEST.

As indicated above, Affected Utilities are not required to divest. Regulatory assets shall be fully recoverable and 100% of stranded benefits associated with generation assets shall be refunded to customers in a manner consistent with the collection of the regulatory assets.

If an Affected Utility can demonstrate that divestiture of any particular generation asset is not practical and not in the public interest, the Commission, in its discretion, may provide the Affected Utility transition revenues, if necessary, to preserve its financial integrity. The allowance of transition revenues will occur only in the event that the Commission determines such transition revenues to be in the public interest. Transition revenues would be calculated in a manner to provide sufficient revenues necessary to avoid default under currently existing financial instruments for a period of ten years, at the end of which time there would be no remaining stranded costs, or to otherwise provide an allocation of stranded cost responsibilities and risks between ratepayers and shareholders as the Commission determines to be in the public interest for a given Affected Utility. The requirements of any true-up mechanism that may be required should be established at the time the Commission acts on an Affected Utility's stranded cost filing.

IV. BENEFITS OF STAFF'S PROPOSED DIVESTITURE PLAN.

Staff's proposed divestiture plan has the general impact of collapsing the Hearing Officer's stranded cost recovery proposal from three separate, alternative methodologies into one basic plan, while allowing an alternative for Affected Utilities which might choose not to participate in the divestiture plan. At page eight of the recommended Opinion and Order, the Hearing Officer sets forth six primary objectives to be taken into consideration in deciding the overall stranded cost issue. Staff's proposed divestiture plan meets the identified primary objectives better than the Hearing Officer's proposal, primarily due to its simplicity.

The first identified objective is to provide Affected Utilities with a reasonable opportunity to collect 100 percent of their unmitigated stranded costs. Staff's proposal ensures that each Affected Utility selecting the divestiture option will have that opportunity. The second identified objective is to provide incentives for utilities to maximize their mitigation efforts. Staff's proposal accomplishes this objective by virtue of the nature of the alternatives provided. Affected

Utilities selecting the divestiture option will maximize the value of their generation assets, thereby minimizing stranded costs. Affected Utilities opting to not divest will only obtain stranded cost recovery in exceptional circumstances, thereby maximizing the incentive to mitigate.

The third identified objective is to accelerate the collection of stranded costs into as short a transition period as possible consistent with other objectives. Staff's proposal comports with this objective by minimizing the amount of stranded costs to be recovered and by providing a market structure that will permit the establishment of a truly competitive electric generation market as soon as possible. The fourth identified objective is to minimize the stranded cost impact on customers remaining on the standard offer. Under Staff's divestiture approach, stranded costs are minimized and the transition to full competition in generation is hastened. Standard offer customers should be generally unaffected during the transition. Similarly, Staff's proposal meets the fifth objective of not confusing customers as to the bottom line by virtue of the relative simplicity of the proposal.

Finally, and perhaps most importantly, Staff's divestiture proposal meets the last stated objective, that of having full generation competition as soon as possible. In Staff's view, the long range objective of a truly competitive and efficient generation market structure should act as a guidepost to the decisions to be made along the way. Staff's divestiture proposal offers the best opportunity to establish an efficient and truly competitive electric generation market as soon as possible. Staff is concerned that any proposal other than a divestiture proposal may inhibit the prospects of ever establishing a market structure that is in society's best interests. Accordingly, Staff has proposed a plan which will be fair and reasonable to all consumers, provide Affected Utilities an opportunity for full recovery of stranded costs, accurately assess the value of any stranded costs, ensure the financial viability of all Affected Utilities and avoid vertical and horizontal market power. Staff's divestiture proposal should be adopted because it is in the public interest to reach these objectives. In addition, it is important to provide real benefits such as rate reductions to customers

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who may not be eligible for competition during the transition period. Staff and the Affected Utilities should be directed to explore appropriate mechanisms to provide such benefits.

RESPECTFULLY SUBMITTED this 29th day of May, 1998.

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Original and ten copies of the foregoing filed this 29th day of May, 1998 with:

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All parties of record

By: Mary Ippolito

STAFF'S PROPOSED AMENDMENT

P. 9, lines 4, delete from "Based on . . ." through line 10, and insert:

> "We believe that divestiture of an Affected Utility's generation units would represent a significant mitigation measure, at least based on testimony that recent auctions of generating units in other states have resulted in sales at substantially in excess of book value. For Affected Utilities that do not choose to divest their generation assets, the best incentive to mitigate is for the Commission to create a risk that not all stranded costs will necessarily be recoverable."

P. 9, lines 22 and 23, delete the sentence beginning "Accordingly,".

P. 10, line 18, delete from "In order to . . ." through line 21 ending with "stranded costs." and insert:

> "Although we cannot go so far as to agree with those parties who advocate that no stranded cost recovery should be allowed for Affected Utilities that do not divest, we do believe that the opportunity for full stranded cost recovery should be available only to those Affected Utilities that choose to divest. For Affected Utilities who do not divest, it is appropriate for the Commission to devise a different approach to deal with a particular set of circumstances. Depending on the situation of given Affected Utility, it may be in the public interest to authorize revenues sufficient to maintain financial integrity, such as avoiding default under currently existing financial instruments during a transition period, or for the Commission to otherwise provide an allocation of stranded cost responsibilities and risks between ratepayers and shareholders.
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> "Whatever stranded costs are authorized for recovery for a given Affected Utility, all Affected Utilities are nevertheless expected to make all reasonable efforts to mitigate stranded costs."

P. 11, line 1, delete "more of".

P. 11, lines 4 and 5, delete the sentence beginning "However,".

P. 11, delete from line 8 beginning with "three options . . ." through line p. 13, line 3, and insert:

"two options: Option No. 1 - Divestiture/Auction Methodology; or Option No. 2 - Transition Revenues Methodology. These options are described below:

STAFF'S PROPOSED AMENDMENT

Option No. 1 - Divestiture/Auction Methodology

The first option is to determine the amount of stranded costs by divesting/auctioning off all generation assets. In addition to the stranded costs defined by A.A.C. R14-2-1601.8, reasonable costs (i.e., costs incurred only after all reasonable efforts at minimization have been undertaken) incurred for premiums, penalties or other payments necessary to effect divestiture; income tax ramifications of divestiture; redemption costs associated with tax-exempt two-county debt which may have to be redeemed upon transfer of the assets (on-going increased debt costs will be eligible for recovery through tariffed rates); and other such reasonable costs necessarily incurred to effectuate divestiture, shall be recoverable as stranded costs. Unmitigated stranded costs shall also include reasonable employee severance and retraining costs necessitated by electric competition, where not otherwise provided.

Each Affected Utility choosing divestiture must, no later than October 1, 1998, file a divestiture plan for Commission approval. Divestiture must be completed no later than January 1, 2001. No Affected Utility or its affiliate may purchase generation assets at any divestiture auction of any Affected Utility. However, an Affected Utility's affiliate may purchase the assets of another Affected Utility, if the Affected Utility's affiliate establishes that it is the highest value bidder and that the purchase will not create or exacerbate significant market power problems. In a divestiture situation, in no event shall an Affected Utility or its affiliate be allowed to purchase the Affected Utility's own generating assets.

An Affected Utility shall be permitted to collect 100 percent of its stranded cost, including a return on its unamortized balance, over a ten year period. The Commission will work with the Affected Utility to provide sufficient assurances in order to avoid triggering write-offs. If the stranded cost amount is determined to be negative, ratepayers shall be entitled to receive 100 percent through a refund, negative surcharge, or other mechanism as approved by the Commission. All customers of the Affected Utility shall pay their appropriate share of stranded costs through a CTC, or a standard offer rate. Stranded cost or other transition revenues authorized by the Commission shall be collected over no longer than ten years.

STAFF'S PROPOSED AMENDMENT

Option No. 2 - Transition Revenues Methodology

> The second option would be to provide sufficient revenues necessary to maintain financial integrity, such as avoiding default under currently existing financial instruments for a period of ten years, at the end of which time there would be no remaining stranded costs, or for the Commission to otherwise provide an allocation of stranded cost responsibilities and risks between ratepayers and shareholders as is determined to be in the public interest for a given Affected Utility."

P. 14, line 7 ½, add:

"In addition, as stated above, the Rule should be clarified that additional costs may also be included in stranded costs, such as costs related to divestiture or to retraining of workers whose jobs are lost because of competition, and costs related to or resulting from divestiture."

P. 18, delete lines 6 through 8, and insert:

"Of the options approved herein, Option 1 requires a true-up. In addition, Option 2 may require a true-up to the extent that the Commission authorizes recovery of a particular amount of stranded costs. The requirements of any true up mechanism should be established at the time the Commission acts on an Affected Utility's stranded cost filing."

P. 18, delete from line 20, beginning "Any stranded . . ." through line 22, and insert:

"We also believe that it is crucial to even go beyond this, and provide real benefits such as rate reductions to customers who may not be eligible for competition during the transition period. We will therefore direct both Staff and the Affected Utilities to explore appropriate mechanisms to provide such benefits."

P. 23, delete lines 10 and 11 and insert:

"33. Stranded cost or other transition revenues authorized by the Commission should be collected over no longer than ten years, although particular circumstances and objectives may dictate a shorter or longer period."